


Office of City Auditor Memorandum



Date: March 27, 2012

To: City Councilmember Jean Godden; Chair of the City Council Libraries, Utilities and Center Committee

From: David G. Jones, City Auditor 

Subject: Office of City Auditor Work Plan to Improve Seattle Public Utilities' Financial Controls

Introduction

What follows is the Office of City Auditor's response to your March 12, 2012 letter concerning future reviews of Seattle Public Utilities' (SPU) financial practices and oversight in light of the recent arrest of a former SPU employee for allegedly stealing over \$1 million in SPU revenues. As you requested, we developed a plan that consists of short and long term actions to be taken by our office, and we added a third category – medium term actions.

Simply performing more audits will not guarantee that fraudulent behavior will never occur at SPU. However, ensuring that a minimum level of auditing will be performed at SPU by independent parties will help decrease the odds that such behavior will occur or go undetected. While it will take time and additional resources to audit all of SPU's important internal controls¹ and revenue streams, this should not deter us from beginning to systematically work towards this goal.

Background

The recent alleged theft involved funds from one of SPU's **secondary revenue streams** (i.e., revenues obtained by SPU that are not covered in customers' standard utility bills for water, solid waste, drainage, or wastewater services). There are five levels of work that could be performed over SPU's secondary revenue streams:

1. Identifying the secondary revenue streams,
2. Assessing the level of risk associated with the revenue streams to determine which need to be audited or reviewed soonest,

¹ Internal controls are things an organization does to help ensure that it meets its objectives and manages risk, and they play a major role in preventing and detecting fraud. Examples include written policies and procedures, authorization signatures, an accounting system, management reviews, segregation of duties, training of staff, audits, security systems, and standardized hiring practices.

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3. Determining which have controls in place (e.g., policies and procedures),
4. Evaluating the quality of the existing controls over a specific secondary revenue stream, and
5. Testing a representative sample of transactions for one or more specific secondary revenue streams to determine compliance with policies and control procedures.

Each layer requires more time to review, with the fifth layer, transaction testing, typically being the most labor intensive.

It should be noted that since 2007, our office has issued five audit reports on SPU's **primary revenue streams** (drainage, transfer stations, commercial solid waste, water, and wastewater), and we plan to eventually complete a report on another of these primary streams, that being SPU's residential solid waste revenue stream. Furthermore, in 2010 and 2011, we issued follow-up reports on the implementation status of all of the open audit recommendations made in the five published reports. Finally, we are currently using data mining software to review certain types of transactions made to SPU and Seattle City Light customer accounts in the City's utility billing system, known as the Consolidated Customer Service System (CCSS).

Recent actions taken by our office in response to your letter

Before we present the details of our plan, we'd like to update you briefly on what we have done to date to respond to your letter. First, we and SPU officials met with representatives from the Seattle Police Department, the King County Prosecutor's Office and the Seattle City Attorney's Office to ensure that any audits we plan at SPU will not interfere with the judicial process involving the recently arrested former SPU employee, Mr. Chau Phan. They told us that our plans will not interfere with that process.

Second, we met with SPU and Department of Finance and Administration (FAS) officials and came to agreement on several key points concerning our office's role in upcoming audits of SPU's secondary revenue streams. FAS plans to hire a consultant to review SPU's internal controls over its secondary revenue streams. We agreed that our office will review and approve the statement of work and deliverables for this consultant contract and will participate in the process to select a consultant. Furthermore, our office will be involved in all significant meetings with the selected consultant and review and approve all of their deliverables.

Third, our office has initiated an audit of the water main extension revenue stream from which Mr. Phan allegedly stole money. We have assigned two auditors from our office to work on this audit, and SPU has agreed to loan us two of their staff part-time to assist with the audit; these SPU staff will be supervised by the Office of City Auditor.

Fourth, our office will review any financial controls assessments that SPU conducts on activities not already addressed by our office or FAS's consultant. This will include reviewing SPU's analyses, new policies and procedures, and other documents.

Action plans

The following is a summary of our plans for auditing the internal controls over SPU's secondary revenue streams, as well as expanding audit coverage to other areas.

While our short term actions are focused on the secondary revenue stream in which the alleged theft occurred, we believe that in the longer term audits will need to be undertaken of SPU's internal controls in many other areas. An organization's internal controls cover a wide area of business processes, including revenues, but also many other things such as inventory, work performed by field crews, safety, capital assets, payroll, expenses², etc.

Short term action plan (i.e., by the end of September 2012)

- 1. On or before August 31, 2012:** We have started and will complete an audit of the internal controls over SPU's water main extension program, with a primary focus on the financial controls (i.e., as opposed to controls, for example, to ensure that any regulatory requirements or construction standards are met). We will possibly expand the audit's scope to include the financial controls over water connections projects, but this will depend on whether this makes sense from an audit efficiency standpoint.

By September 30, 2012:

- 2.** We will complete a risk assessment of SPU's secondary revenue streams that will determine the priority of audits in this area, and whether certain streams do not warrant audits at this point. This will include developing estimates of the hours required to complete each audit. We will also use our risk assessment results to determine whether any of the high risk revenue streams would benefit from auditing by a consultant. Finally, in determining which secondary revenue streams should be audited by our office, we will consider the results of any risk assessments performed in this area by SPU or the consultant hired by FAS.

² SPU has asked Moss Adams to review SPU's internal controls over its sundry billing, accounts payable, and payroll systems.

3. By no later than the end of September 2012, our plans are to have hired the new utility auditor authorized by the City Council during the 2012 budget process.
4. We will complete our memo on improvements to the controls over the City's utility billing system, the Consolidated Customer Service System (CCSS), that contains our recommendations for improvements and the responses we received from SPU and Seattle City Light.

Medium term action plan (i.e., by the end of March 2013)

1. Our office will seek to obtain City Council approval to increase the number of auditors dedicated to auditing SPU and Seattle City Light to two FTEs for each utility (i.e., create three new positions in addition to the one utility auditor position authorized during the 2012 budget process). These four positions will provide the independence and institutional knowledge to ensure that an increased level of independent auditing is conducted at the City's two utilities.

Long term action plan

1. We will complete and regularly update a risk assessment of SPU's complete range of activities. This will enable us to develop a schedule for performing audits based on risk and to see what it would take to achieve a regular cycle of audits of significant SPU activities. The City Council and perhaps the recently created Audit Committee will be able to review the list and determine the level of audit coverage it believes is prudent for the City to achieve, and the resources (e.g., audit staff and/or consultants) that will be required to achieve this coverage.
2. We will also seek to increase the office's capabilities in the areas of information technology (IT) auditing and fraud investigation, either through hiring additional staff with expertise in these areas (e.g., hiring someone who is a Certified Fraud Examiner) or by contracting for this expertise. We believe this is necessary because IT systems are used to control and monitor an increasing number of SPU activities, and fraud investigations and fraud prevention and detection programs require specialized expertise.

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3. By working with SPU and the Executive branch, our office would like to help develop and encourage training for SPU and other City department employees on the basics of internal controls, somewhat similar to the training the City already offers on cash handling. Ideally, this training would be tailored for certain type of functions. Such training would be particularly useful for managers and supervisors who need to know how to tell whether their unit's systems of controls are adequate. We note that SPU's March 23, 2012 Work Plan to Improve Financial Internal Controls indicates that they plan on developing and providing internal controls training to their staff during 2012.

If you have any question or concerns about our plans, please contact me at 233-1095 or at davidg.jones@seattle.gov.